

§ 5c.168(f)(8)–1

26 CFR Ch. I (4–1–10 Edition)

168(f)(8), where the lessee's rental payments are substantially equal in timing and amount to the principal and interest payments on the lessor's note, the arbitrage provisions of section 103(c) and §§ 1.103–13, 1.103–14, and 1.103–15 shall apply to any obligations of the lessee (or party related to the lessee) without regard to the section 168(f)(8) lease transaction.

[T.D. 7800, 46 FR 63257, Dec. 31, 1981]

§ 5c.168(f)(8)–1 Special rules for leases.

(a) *In general.* Section 168(f)(8) of the Internal Revenue Code of 1954 provides special rules for characterizing certain agreements as leases and characterizing the parties to the agreement as lessors and lessees for Federal tax law purposes. These rules apply only with respect to qualified leased property. If all the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11 are met, then the agreement shall be treated as a lease, and the party characterized as the lessor shall be treated as the owner of the property. In such case, the lessor shall be deemed to have entered into the lease in the course of carrying on a trade or business and shall be allowed accelerated cost recovery system (ACRS) deductions under section 168 and the investment tax credit under section 38 with respect to the leased property.

(b) *Exception for qualified research expenditures.* For purposes of section 44F(b)(2)(A)(iii), the determination of whether any amount is paid or incurred to another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8). Thus, if a lessee would be considered the owner of the property without regard to section 168(f)(8), any amounts paid by the lessee under the lease shall not be considered amounts paid or incurred for the right to use the property.

(c) *Other factors disregarded.* If an agreement meets the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11, the following factors will not be taken into account in determining whether the transaction is a lease:

(1) Whether the lessor or lessee must take the tax benefits into account in order to determine that a profit is made from the transaction;

(2) The fact that the lessee is the nominal owner of the property for State or local law purposes (*e.g.*, has legal title to the property) and retains the burdens, benefits, and incidents of ownership (such as payment of taxes and maintenance charges with respect to the property);

(3) Whether or not a person other than the lessee may be able to use the property after the lease term;

(4) The fact that the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value at that time;

(5) The fact that the lessee or related party has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10 percent investment); and

(6) The fact that the obligation of any person is subject to any contingency or offset agreement. See, for example, the rent and debt service offset in Example (2) of paragraph (e).

An agreement that meets the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11 may be treated by the parties as a lease for Federal Tax law purposes only. Similarly, a sale by the lessee of the leased property to the lessor in a transaction where the property is leased back under an agreement that meets the requirements of section 168(f)(8) may be treated by the parties as a sale for Federal tax law purposes only. The agreements need not comply with State law requirements concerning transfer of title, recording, etc.

(d) *Ownership in one of the parties.* Notwithstanding any other section, if neither the lessor nor the lessee would be the owner of the property without regard to section 168(f)(8), or, if any party with an economic interest in the property (other than the lessor or lessee or any subsequent transferee of their interests) claims ACRS deductions or any investment tax credit with respect to the leased property, an election under section 168(f)(8) with respect to such property shall be void as of the

date of the execution of the lease agreement.

(e) *Examples.* The application of section 168(f)(8) and §§ 5c.168(f)(8)-2 through 5c.168(f)(8)-11 may be illustrated by the following examples:

Example (1). X Corp. wishes to acquire a \$1 million piece of equipment which is "qualified leased property" as defined in section 168(f)(8)(D). The equipment has a 10-year economic life and falls within the 5-year ACRS class. Y Corp. is a person meeting the qualifications set forth in section 168(f)(8)(B)(i) and § 5c.168(f)(8)-3 and wishes to be the owner of the property for Federal tax law purposes. Y therefore purchases the equipment from the manufacturer for \$1 million, paying \$200,000 in cash and borrowing \$800,000 from a bank (payable over 9 years and requiring nine equal annual payments of principal and interest of \$168,000). Y then leases the equipment to X under an agreement providing for nine annual rental payments of \$168,000, and the parties elect in accordance with the provisions of section 168(f)(8)-2 to have the provisions of section 168(f)(8) apply. The timing and amount of the rental payments required to be made by X (the "lessee-user") under the lease will be exactly equal to the timing and amount of the principal and interest payments that Y (the "lessor") will be required to make to the bank under its purchase money note. Under these circumstances, Y is treated as the owner and lessor of the property for Federal tax law purposes; it therefore is entitled to the investment tax credit and the ACRS deductions with respect to the property. Y's basis in the property is \$1 million. Y must report the rent as income and will be entitled to deduct the interest on the purchase money note. The aggregate payments required to be made by X under the lease are treated as rent in accordance with § 5c.168(f)(8)-7 and are deductible as such.

Example (2). The facts are the same as in example (1) except that X purchases the equipment for \$1 million and wishes to transfer ownership of the property for Federal tax law purposes to Y under a sale and leaseback arrangement. Accordingly, X sells the property to Y for \$200,000 in cash (which represents the agreed upon compensation for the tax benefits to be enjoyed by Y as lessor) plus a 9-year, \$800,000 note calling for nine \$168,000 annual payments of principal and interest. Y then leases the property back to X under an agreement providing for nine annual rental payments of \$168,000. The parties elect in accordance with the provisions of § 5c.168(f)(8)-2 to have the provisions of section 168(f)(8) apply. The timing and amount of the rental payments required to be made by X (as the lessee-user) under the lease will be exactly equal to the timing and amount of

the principal and interest payments that Y will be required to make to X under Y's purchase money note, so that the only cash transferred between X and Y is the \$200,000 down payment. Y's obligation to make debt service payments on the note is contingent on X's obligation to make rental payments under the lease. Under these circumstances, Y is treated as the owner and lessor of the property for Federal tax law purposes; it therefore is entitled to the investment tax credit and ACRS deductions with respect to the property. Y's basis in the property is \$1 million. Y must report the rent as income and will be entitled to deduct the interest on the purchase money note. No gain or loss will be recognized by X on the sale of the property since the sale price equals X's basis in the property. X must report as income the interest paid by Y on the note and will be entitled to a deduction for the rental payments it makes under the lease in accordance with § 5c.168(f)(8)-7.

Example (3). Assume that in both examples (1) and (2) X has an option to purchase the equipment at the end of the lease term for \$1.00. The fact that the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value is not taken into account in determining the status of the transactions as leases under section 168(f)(8).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56148, Nov. 13, 1981]

§ 5c.168(f)(8)-2 Election to characterize transaction as a section 168(f)(8) lease.

(a) *Election—(1) In general.* The election to characterize a transaction as a lease qualifying under section 168(f)(8) shall be made within the time and manner as set forth in this section without regard to section 168(f)(4).

(2) *Lease agreement.* For an agreement to be treated as a lease under section 168(f)(8) and this section, the lease agreement must be executed not later than 3 months after the property was first placed in service, as defined in § 5c.168(f)(8)-6(b)(2)(i) (or prior to November 14, 1981, if the property was first placed in service by the lessee after December 31, 1980, and before August 14, 1981). The agreement must be in writing and must state that all of the parties to the agreement agree to characterize it as a lease for purposes of Federal tax law and elect to have the provisions of section 168(f)(8) apply to the transaction. The agreement